Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Nakano	Analyst:	John Pavalasky	Bill Number:	AB 116
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	01-18-01
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion/Gain From Sales of Qualified Small Business Stock Held More Than 5 Years/Allow 100%

SUMMARY

This bill would allow individuals to not pay regular tax on the gain from the sale of stock in certain small businesses issued on or after the date the bill is enacted. In order to qualify for this treatment, the stock must be held for a minimum of five years.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to increase the incentive for investment in California small businesses, thus creating more jobs and keeping the state economy strong.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under both federal and California law, noncorporate investors may exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock that has been held for more than five years. The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to the greater of $10 million ($5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

To qualify as small business stock for federal purposes, the stock must be that of a C corporation. The total gross assets (treating all members of the same parent-subsidiary controlled group as one corporation) of the C corporation at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, must not exceed $50 million.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Gerald H. Goldberg	02/20/01
______ SA	______ O	______ NAR		
______ N	______ OUA	__X__ PENDING		

The C corporation must meet certain reporting requirements. During substantially all of the taxpayer's holding period for the stock, the C corporation (other than certain excluded corporations) must meet an active business test. The taxpayer claiming the exclusion must have acquired the stock when the stock was originally issued for money or other property (not including stock) or as compensation for services provided to the C corporation.

To qualify as California qualified small business stock, the issuer must meet the following additional rules:

1. Must be doing business in California at all times on or after July 1, 1993;

2. Must have assets of $50 million or less, when measured as a controlled group using modified federal rules, before the issuance of the stock; and

3. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one-half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

THIS BILL

This bill would increase the percentage of gain excluded from income for regular tax purposes **from 50% of the gain to 100%** of the gain for qualified small business stock originally issued on or after the effective date of these amendments in 2001 and held for more than five years. This bill retains the 50% exclusion of the gain for qualified small business stock originally issued before the effective date of the amendments made by this bill in 2001 and held for more than five years.

One-half of the amount of gain excluded under this provision would continue to be treated as a preference item under the alternative minimum tax (AMT).

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881) enacted the 50% capital gain exclusion for small business stock.

SB 1805 (Stats. 1994, Ch. 1243) codified act language from SEC. 28 of Senate Bill 671 (Stats. 1993, Ch. 881), relating to application of federal regulations to California's "stand alone" provision for the 50% exclusion.

SB 715 (Stats. 1996, Ch. 952) adopted the federal tax law definition of "domestic corporation" (a corporation created or organized in the U.S. or any state) and also made technical, nonsubstantive changes that merely eliminated superfluous language.

AB 1120 (Stats. 1999, Ch. 69) removed the original January 1, 1999, sunset date for issuance of new stock that could qualify for the 50% exclusion.

AB 1783, Nakano (1999/2000) would have increased the exclusion from 50% to 100% for stock originally issued on or after the effective date of that act. AB 1783 was held in the Appropriations Committee.

OTHER STATES' INFORMATION

States with similar small business stock exclusions include *Illinois, Massachusetts, Michigan, and New York.* Those states conform to the federal rules that allow noncorporate investors to exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock that has been held for more than five years, without adding the additional targeting to their state requirements that California's provision contains.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>REVENUE ESTIMATE</u>

Projected revenue losses under the Personal Income Tax Law are as follows over the initial three impact years, which commence five years after the assumed date of enactment:

Impact of AB 116 (January 18, 2001) Effective for Purchases After Enactment Date Enactment Assumed after June 30, 2001 (In Millions)		
2006-7	2007-8	2008-9
($35)	($50)	($60)

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this measure.

<u>REVENUE DISCUSSION</u>

The revenue impact of this proposal would depend on the amount invested in qualified business stock after enactment, the rate of growth in the market value of the stock, and the amount realized upon disposition after a minimum holding period of five years.

Estimates above follow the methodology used previously to estimate other proposals dealing with extending/increasing the exclusion, and they allow for the AMT interaction. It is highly speculative what the level of initial public offerings will be for California businesses in the near future, possibly on the order of $10 billion for 2001.

ARGUMENTS/POLICY CONCERNS

This bill could provide an increased incentive for venture capital investments to be made in qualified California small businesses. That is because the stock acquired from those small businesses after the bill is enacted would qualify, when held for at least five years before sale, for an exclusion from income of 100% of the gain on that sale.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335

Brian Putler
Franchise Tax Board
845-6333